



# **The Effects of Changes in Taxation on Grain and Flour Smuggling**

***Restructuring Assistance and  
Policy Advice for the Ministry of  
Agriculture and Food of the  
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## **RESTRUCTURING ASSISTANCE AND POLICY ADVICE FOR THE MINISTRY OF AGRICULTURE AND FOOD OF GEORGIA**

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### **THE EFFECTS OF CHANGES IN TAXATION ON GRAIN AND FLOUR SMUGGLING<sup>1</sup>**

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Georgia has never produced enough grain and flour to meet its own needs in modern times. Increases in customs duties and other taxes in 1998 dramatically increased the incentives for smuggling flour from neighboring states into the country. Although tax exceptions are generally a bad policy, the transparency of Georgia's borders, the fact that most of the smuggling originates in the Russian Federation, and the impracticality of raising consumer prices for a basic food commodity means that the only practical way to combat this traffic is through changes in the tax regime. Moreover, it makes little sense for a country which must import grain in order to feed its population to maintain a high tariff on such imports—at best, this system protects inefficient domestic producers, the very former collective and state farms which need to be reformed in order to be viable agricultural businesses.

#### **How much bread wheat does Georgia need?**

The physiological norm for daily bread consumption is 350 grams per person. However, in Georgia approximately 450 grams per person per day have historically been consumed, and 450 grams of bread per day was the amount allowed when rationing was enforced earlier in this decade. Since the present resident population of Georgia, excluding Abkhazia and Osetia, is 4,600,000 people, the annual demand for bread can be estimated at 765,000 tons.

When flour is baked into bread or macaroni the final product weighs 31 percent more than the flour used to make it. So 584,000 tons of flour produces 765,000 tons of bread and grain products. Milling wheat yields 73 percent flour by weight. So approximately 800,000 tons of wheat must be milled to produce 765,000 tons of bread and grain products.

There is substantial variation in wheat quality, with the higher-quality grain used for milling and human consumption, while lower grades are used for animal feed and industrial purposes. Given the current cattle population in Georgia, another 420,000 tons of wheat is needed for feed and industrial use. Human grain consumption in Georgia is almost entirely wheat. Animal feed and industrial use requires various grains, including substantial amounts

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of wheat. Georgian practice conventionally recalculates statistics for use other than human consumption of any grain into wheat equivalent.

Table 1 Production of Grain Products in Georgia, 1985-2000 tons				
Calendar year	Gross harvest, wheat (cleanweight)	Flour	Bread and Grain Products	Mixed feed
1985	185,000	930,000	900,000	1,108,000
1990	275,000	952,000	856,000	1,080,000
1991	226,000	847,000	1,005,000	839,000
1992	206,000	579,000	760,000	347,000
1993	125,000	463,000	640,000	161,000
1994	98,000	420,000	498,000	136,000
1995	125,000	334,000	296,000	84,300
1996	179,000	211,000	262,000	37,400
1997	311,000	165,000	199,000	22,000
1998	145,000	142,000	174,000	11,000
1999	230,000	114,000	114,000	4,800
2000	90,000	101,000	109,000	2,700

Source: State Department for Statistics, unpublished.

“Bread and grain products” are all edible items made from grain, including bread, rolls, cakes, pasta, etc.

Not all wheat is suitable for milling, but data on the amount of each harvest milled is not available.

### Effects of 1998 customs duty and tax changes on flour and bread-production

On average for 1990-2000, Georgian domestic production has covered only about 10 percent of annual demand for food grain. So established Georgian flour mills process mostly imported grain. Bakeries may either buy flour from Georgian mills or purchase flour from abroad.

Until 1998, wheat grain could be imported into Georgia duty-free. On January 1, 1998, 20 percent VAT and a 12 percent import duty were imposed on imports of flour and grain products, but on May 13 of that year the VAT on imported flour was reduced to 7 percent. Parliament then amended the tax code on October 30, 1998 (law number 1666-1) to impose an import duty of 12 percent of the customs value of imported wheat and flour and a VAT of 20 percent on all flour, bread, and grain products, imported and domestic. These changes in import duties took effect on November 28, 1998.

There is no evidence that actual consumption of bread and grain products declined in 1998 in comparison to 1997. As table 1 above shows, total registered production of bread and baked goods has fallen about eight times over between 1990 and 2000. Yet during that period consumption of bread and baked goods has been relatively stable at about one million tons annually each year except 1992, the year of civil war. So the total volume of production of bread and grain products in the country must have remained about the same throughout the past decade. What did happen after the tax increases in 1998 is that tax-paying domestic flour mills and bakeries reduced their output, as is shown by the fact that for 1998 as a whole,

budgetary revenues from taxes generated by the milling and baking industries were about 19 million GEL, approximately the amount collected from them in the first six months of 1997.

So there is a difficulty in the data. Registered, and taxed, production of flour and bread has been declining but consumption has not been during the 1990s. Indeed, given the fall in standard of living, it is reasonable to expect there might have been some increase in bread and grain products consumption during the 1990s, although this growth might have been masked by the concurrent fall in population.

### Grain and flour imports

Since production fell and consumption remained relatively steady during the 1990s, the difference must have been made up by imports. Compiling data from the State Department of Statistics, Customs and the Ministry of Agriculture and Food produces table 2. (Import data for 1990 and 1991, when Georgia was still part of the USSR and much grain was passed through the country's ports to other republics, are not available.) All shipments of humanitarian aid wheat grain and flour are included in these numbers.

Table 2 Imports of wheat and wheat flour to Georgia, 1992-2000 tons				
	wheat grain		wheat flour	
1992	607,100		90,400	
1993	677,400		102,000	
1994	643,800		93,800	
1995	496,100		40,300	
1996	457,050		185,600	
1997	356,310		134,900	
1992-1997 average		539,627		107,833
1998	217,200		111,852	
1999	161,100		85,603	
2000	202,500		130,625	
1998-2000 average		193,600		109,360
Total	3,818,550		37,907,865	
1992-2000 average		424,284		108,342

Source: compiled by author from data provided by Ministry of Agriculture and Food, Customs Service, State Department of Statistics and Ministry of Tax Revenues.

Inspection of this table indicates that recorded flour imports have remained relatively constant since 1992. Recorded wheat grain imports fell after the customs duty was imposed on them. Yet consumption has remained steady since 1997 (Table 3). Reported grain stocks have somewhat increased during 1997-2000. In the absence of a remarkable breakthrough in the efficiency or basic technology of Georgian bread baking and macaroni production, the only way to account for this situation is to assume a large growth in unregistered import of wheat grain and flour. There is no way to know whether the increased smuggling involved more wheat, more flour, or both. However, since flour is a higher-value product than wheat and requires no further processing before sale to a consumer (for instance by market vendors), it is likely that the increased smuggling was mostly flour, not unmilled grain.

Table 3  
Wheat Flour (grain equivalent) Balance, Calendar Years 1997-2000  
tons

	1997	1998	1999	2000
Stocks at beginning of year	112,200	128,200	153,600	146,000
Domestic production	295,000	145,000	225,000	89,000
Registered import	491,000	367,600	343,800	390,000
Unregistered import	314,000	587,400	530,200	621,000
Total stocks (1+2+3+4)	1,212,000	1,228,200	1,253,600	1,246,000
Losses	36,000	36,800	37,600	37,400
Exports	2,500	13,600	14,900	20,000
Stocks at end of year	128,000	153,600	146,000	122,000
Consumption of Bread products, total	1,041,530	1,020,200	1,054,800	1,066,600

Source: compiled by author from data provided by Ministry of Agriculture and Food, Customs Service, State Department of Statistics and Ministry of Tax Revenues.  
“Unregistered import” calculated by author from consumption.

### Illegal Imports

The preceding analysis strongly suggests that smuggling of flour into Georgia has increased dramatically since the import duties on wheat grain were imposed in 1998.

Speaking unofficially, sources in the Customs Service estimate that in 1998-2000 the relative amounts of flour smuggled into Georgia from other countries have remained relatively constant, with the most smuggled flour coming in from the Russian Federation (approximately 70 percent of the total smuggled), mostly through the Ergneti market in the Tskhinvali region (South Osetia). About 25 percent of the smuggled flour comes from Turkey through Ajara. About 5 percent of the smuggled amounts come from Azerbaijan, but most of that is compound feed, not flour.

Since the smuggled flour is not taxed at all, it not only depresses customs revenues, but also significantly undersells legal domestically-produced flour, which is taxed. So there is a considerable incentive for producers to use the smuggled flour in preference to the legal product, which will also tend to increase the amount of home- and small-batch commercial baking. Moving production of bread from large commercial bakeries to smaller ones is likely, as a side effect, to make collection of taxes on bread and bread production more difficult.

### Effects on consumers

Throughout Georgia, consumer prices for basic bread remain effectively controlled. The official price for a standard round, which in 1996 was 0.63 GEL per kilo in Tbilisi, has risen by about 2 percent annually since then. However, the bakers have also steadily reduced the weight of the standard round from 800 grams in 1996 to approximately 500 grams at present. Without considerable further analysis to allow for inflation of the currency as well as changes in weight and composition, it is impossible to say just how these changes have affected the consumer. However, it is certain that the price controls continue to act as a hidden subsidy to consumers, and that consumers themselves continue to pay a very great percentage of their income for basic foodstuffs, including a great deal of bread and grain products.

In principle, the effectiveness of customs controls at the country's borders should be greatly increased through improved enforcement. However, given the presence of major Russian military bases, the continuing disputes over Abkhazia and the Tskhinvali region, as well as the large degree of autonomy of Ajara, and the flows of refugees that result from these situations, improved administrative enforcement has turned out to be extremely difficult. Moreover, the national political authorities have every reason to wish to keep urban food prices, especially for bread and grain products, as low as possible, even if that impacts revenues, in order to lessen the chances of civil disorders.

The only feasible alternative method to combat the smuggling and improve the quality of local bread and grain products is to make local production more competitive. Increases in efficiency will eventually achieve this goal if there are incentives for such improvements to be made. Tax reductions are the most logical way to provide such incentives.

### **Proposals for change in the tax regime**

The following changes in the tax regime on grain and grain products have been proposed:

- Exempting imports of wheat grain from VAT
- Reducing VAT on domestically-produced flour and macaroni to 10 percent
- Imposing a customs duty of 20 percent on imported flour
- Reducing VAT paid on imported flour to 10 percent (equivalent to the VAT on domestic production)
- Eliminating VAT on bakery products, instead imposing a fixed monthly tax on bakeries of 140 GEL per square meter of their production floor space.

Since the tariff on imported flour is counted in its value when VAT is assessed, the total duty paid on flour imports would amount to 32 percent of the customs value of the import.

The proposals on the fixed tax for bakeries submitted to Parliament by President Shevardnadze on March 20, 2001, would have amended Article 273 of the Tax Code of Georgia as follows:

43. Before January 1, 2005:

- a) A unified fixed tax should be established for bread and bakery production enterprises (physical as well as legal persons) instead of the taxes imposed by current legislation (VAT, profits tax, social tax, income tax, individual entrepreneur tax, economic activity tax and road fund taxes).
- b) The rate of the unified fixed tax is 600 GEL per month for every ton of capacity of a bakery. In addition, VAT paid for the goods, works and service used for the economic activity of production is not subject to crediting.
- c) Capacity of the bakery is calculated according to the established procedure, considering the actual assortment [of products] and baking technology, minus capacity that has been withdrawn from use ["mothballed"—translator] by the appropriate procedure. Permanent commissions of the tax agencies shall oversee the process of determination of capacity of an enterprise and the process of withdrawal of production capacity from use. The commissions are to be composed of employees of the tax agencies, the bakeries, the Ministry of Agriculture and Food, the Ministry of Economy, Industry and Trade, the Ministry of Finance and other interested parties.

d) The unified fixed tax should be paid on a monthly basis no later than the fifteenth of the month following the month being accounted for.

This law takes effect upon publication.

The current version of the proposal substitutes the area of production floor space in square meters for production capacity “as calculated according to the standard procedure.” The Ministry of Agriculture and Food estimates that the country’s bakeries have a total of 8,000 square meters of production floor space, so that predicted revenues from this new tax are 13.4 million GEL annually. The advantage of such a tax regime is that it does not require accurate account of the amount of bread and baked goods produced.

These proposals are sensible when considered together. Smuggled flour could be freely used by bakers, but since there would no longer be duty on imported grain, the domestic flour mills would be able to increase their supplies and produce flour that would be reasonably competitive with imports.

A ton of legally-imported flour is now valued at 400 GEL at the Georgian border. The technology and efficiency of flour milling is approximately equivalent in Georgia and the regions of the Russian Federation from which most smuggled flour probably comes. So production costs for flour are likely to be about equivalent in Russia and Georgia, and a ton that will be smuggled through the border probably has about the same production and transport costs as a ton that will be declared. Whether the ton of flour is legally or illegally imported, transportation costs to the bakery must be added. In addition, the smuggler must pay substantial bribes in order to move his goods. It is reliably estimated that the cost in bribes for an illegal movement of flour within Georgia is about 50 GEL per ton, eight to ten times more than the cost in bribes for a legal (properly documented) shipment of the same size over the same distance. So a smuggled ton of flour would cost about 450 GEL at the bakery door in Tbilisi.

Under these proposals, for a legally-operating, tax-paying Georgian flour mill, the price of imported wheat would be reduced by GEL 65 per ton (taking the price of class 2 or class 3 wheat to be 390 GEL including VAT as at present), so that a ton of imported wheat would cost the flour mill approximately 325 GEL including transport. A ton of local flour now costs approximately 500 GEL, so the price of a ton of wheat flour from legally imported grain at the 0 tariff rate would be about 450-460 GEL. As a result, legally-produced domestic flour would be competitive with the smuggled product, and the smugglers’ profit would become so small and uncertain that smuggling would cease to be an attractive business. They would either become legal importers (with a much smaller profit margin but increased revenue to the customs) or they would cease to import their flour. In either case the local flour milling industry would benefit from increased competitiveness of its product and its new profitability would be multiplied in the Georgian economy.

Most marketed grain in Georgia comes from large former collective and state farms. Allowing duty-free grain import would force those farms to face foreign competition. They would have to become more efficient to meet that competition, or find other lines of business. In either case, these proposals would encourage the transfer of agricultural assets into the hands of users who could use them more efficiently. Although the large domestic microfarm (subsistence) sector also produces considerable grain, very little of what it produces is marketed in any form, so those producers would not be affected by these proposals.

### Annex

Correlation Matrix of relationships between domestically-produced and imported wheat grain and value-added commodities.

A correlation matrix was developed to determine the degree and nature of the relation among locally produced and imported wheat grain and value-added commodities.

		Domestic				Imported	
		Grain	Flour	B&GP	Mixed Feed	Grain	Flour
Domestic	Grain	1	-0.19	-0.14	-0.05	-0.23	0.22
	Flour		1	0.98	0.94	0.91	-0.38
	B&GP			1	0.95	0.89	-0.25
	Mixed Feed				1	0.75	-0.32
Imported	Grain					1	-0.19
	Flour						1

A very significant positive relation was estimated among imported wheat grain and locally produced flour (0.91), bread and grain products (0.89), and mixed feeds (0.75), implying that these variables follow the same trend, an increase in imported grain volume is associated with/accompanied by an increase of locally produced value-added, and vice versa. The results derived support the suggestion to stimulate local value-added production through increase of wheat imports.

On the other hand, flour imports held an inverse relation with locally produced flour (-0.38), bread and grain products (-0.25), and mixed feeds (-0.32), implying that an increase in imported flour volume is associated with/accompanied by a reduction of grain value-added production in Georgia, and vice versa, although the degree of this negative association is weak. These results, as in the previous case, support the proposal to reduce indirectly flour imports, despite the fact that the derived correlation coefficient is insignificant.